Hard Choices In China Trade Dispute

The music products industry is bracing for major disruption as the Trump Administration proposes stiff new tariffs on Chinese imports. On May 10, when it appeared that China had reneged on previously agreed upon conditions that loosened restrictions on foreign investment and reduced barriers for imports, the Administration upped tariffs from 10% to 25% on "List 3" of Chinese imports, which included electronic sub-assemblies, bags and cases, power supplies, stands, and a host of other products. If U.S. and Chinese trade negotiators can't hammer out a trade agreement by early July, the Administration threatens to impose a 25% tariff on "List 4" products, which include virtually all music and audio products including guitars, band instruments and pianos.

The stakes for these negotiations are extremely high. Based on the most recent import data provided by the United States Census Bureau, Chinese musical instrument and audio product imports accounted for close to 40% of the U.S. industry's $7.5 billion in retail value. Factor in the value of component parts, like circuit boards, guitar hardware, stamped metal parts, and knobs and switches that will also be subject to tariffs, and the share is even higher. If negotiations break down, the overnight 25% price increase on such a broad array of merchandise is bound to have an impact. There are no businesses that we know of capable of absorbing an abrupt 25% cost hike, so expect price hikes. Suppliers and retailers tell us that they will sacrifice margin points to reduce the impact, but there will still be some "sticker shock" at the point of purchase as higher costs are passed on to the consumer.

One of the iron laws of economics is that higher prices suppress demand, but it's not clear the extent to which a double-digit jump in retail prices will deter music buyers. Since most music products are discretionary and can be easily deferred, there is good reason to worry about a coming hit to the top line. On the positive side, the fact that consumers in the recent past have willingly paid far more for music products should provide some comfort: prevailing industry prices are currently at a historic low when adjusted for inflation.

If the 25% Chinese tariffs stick, expect the industry to seek out new sources of supply. Manufacturers we talk to have already begun exploring production sites in Mexico, Vietnam, Thailand, Malaysia, Indonesia, and even the U.S. To cite one example, OEM guitar manufacturers in Indonesia report a significant uptick in new orders. However, the specialized skills required to produce music products take time to develop, so major shifts in production sites, in the best case, will take place over a period of years.

Economists, dating back at least to Adam Smith, author of the 1776 classic *The Wealth of Nations*, have made a compelling case against tariffs. They argue that restrictive import duties impoverish the buying public, while also propping up inefficient domestic industries and misallocating finite resources. There is ample empirical evidence to bolster their arguments: Scan the globe and it's no accident that the world's more prosperous nations are uniformly defined by open markets and limited tariffs.

Adam Smith and his acolytes would no doubt take a dim view of the potential 25% China tariffs. However, there are mitigating circumstances that warrant consideration. To put it bluntly, China doesn't play by the rules: It places restrictions on foreign imports and has shown little respect for trademarks, patents, or other intellectual property. In or out of the music products industry, just about every manufacturer with a prominent brand regularly complains of counterfeiting in China that goes unpunished. A recent story we carried about a Chinese factory getting shut down for producing knock-off Shure mics was noteworthy simply because it was one of the rare instances when the Chinese government took action.

The case of Gibson Guitars puts the importance of intellectual property in stark relief. Last year, the private equity firm KKR valued the guitar maker at somewhere between $450 and $525 million. Hard assets, including inventories, receivables, and plant property and equipment, accounted for about $150 million of the valuation; the Gibson trademark and product designs accounted for the rest. Thus for Gibson, like many others, intellectual property is its most valuable asset. When Chinese companies are allowed to steal these assets, a company like Gibson suffers both lost revenue and reputational damage. So how should U.S. policy makers respond to this widespread abuse?

We don't have the answer, and given their numerous changes in positions, we're not sure the Trump Administration does either. But using tariffs to pressure China to respect intellectual property is not an unreasonable idea. It's also not bad politics. The approach could have an outsized impact on the music products industry, but its effect on the U.S. economy would be far less significant. Economists at the International Monetary Fund estimate that only 2.4% of the $21.1 trillion U.S. economy is tied to exports at risk from higher Chinese tariffs. Trade officials probably view any damage to industries, like ours, dependent on China, as acceptable collateral damage in pursuit of larger policy goals. Let's hope that some accommodation can be reached that combines protection of intellectual property with the free flow of products.

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